

June 25, 2004

EX PARTE – Via Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: *Implementation of the Local Competition Provisions of the
Telecommunications Act of 1996*, CC Docket No. 96-98;
Intercarrier Compensation for ISP-Bound Traffic, CC Docket No. 99-68;
Level 3 Petition for Forbearance, WC Docket No. 03-266;
IP-Enabled Services, WC Docket No. 04-36

Dear Ms. Dortch:

On Thursday, June 24, 2004, Cindy Schonhaut, Director of Federal Regulatory Policy for Level 3 Communications LLC (“Level 3”), and Level 3’s counsel, John T. Nakahata and Charles D. Breckinridge of Harris, Wiltshire & Grannis LLP, met with Christopher Libertelli, Senior Legal Advisor to Chairman Powell; William Maher, Chief of the Wireline Competition Bureau; Jane Jackson, Associate Chief of the Wireline Competition Bureau; Robert Tanner, Legal Counsel to the Wireline Competition Bureau; Margaret Dailey, Legal Counsel to the Wireline Competition Bureau; Tamara Preiss, Chief of the Pricing Policy Division; Steve Morris, Deputy Chief of the Pricing Policy Division; Jennifer McKee, Assistant Chief of the Pricing Policy Division; Victoria Schlesinger, Attorney Advisor in the Pricing Policy Division; and Rodger Woock, Chief of the Industry Analysis and Technology Division.

The participants in these meetings discussed the proceedings identified above. Level 3 argued that the Commission should reject contentions that traffic bound for Internet Service Providers falls outside of Section 251(b)(5) of the Communications Act of 1934. As set forth more fully in its *ex parte* filing dated June 23, 2004 (CC Docket Nos. 96-98 and 99-68), Level 3 explained that these contentions conflict with the language of the Act, with the Commission’s and the courts’ interpretations of the Act, and with the Commission’s efforts to establish a uniform intercarrier compensation system. With respect to its forbearance petition and the *IP-Enabled Services* docket, Level 3 reiterated arguments presented in its petition, its written reply comments in support of its petition, and in its written comments in the *IP-Enabled Services* proceeding.

Ms. Marlene H. Dortch

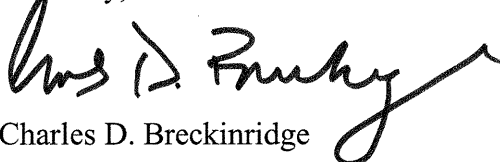
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In the course of the meetings, Level 3 distributed sections of a report prepared by Bernstein Research Call. A copy of the distributed sections is attached to this letter.

In accordance with the Commission's rules, I am filing this letter electronically in the dockets identified above.

Sincerely,

A handwritten signature in black ink, appearing to read "Charles D. Breckinridge", with a long, sweeping horizontal stroke extending to the right.

Charles D. Breckinridge

cc Christopher Libertelli, Senior Legal Advisor to Chairman Powell
William Maher, Chief of the Wireline Competition Bureau
Jane Jackson, Associate Chief of the Wireline Competition Bureau
Robert Tanner, Legal Counsel to the Wireline Competition Bureau
Margaret Dailey, Legal Counsel to the Wireline Competition Bureau
Tamara Preiss, Chief of the Pricing Policy Division
Steve Morris, Deputy Chief of the Pricing Policy Division
Jennifer McKee, Assistant Chief of the Pricing Policy Division
Victoria Schlesinger, Attorney Advisor in the Pricing Policy Division
Rodger Woock, Chief of the Industry Analysis and Technology Division



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DSL Economics I: Continued Broadband Adoption to Drive 22% DSL Revenue Growth Through 2008

Ticker	Rating	CUR	10/14/2003 Closing Price	Target Price	YTD Rel. Perf.	EPS			P/E			Yield
						2002A	2003E	2004E	2002A	2003E	2004E	
SBC	O	USD	21.40	30.00	-40.3%	2.24	1.64	1.53	9.6	13.0	14.0	5.3%
VZ	M	USD	31.50	38.00	-38.0%	3.05	2.57	2.31	10.3	12.3	13.6	4.9%
BLS	M	USD	23.59	29.00	-28.1%	2.09	2.04	1.95	11.3	11.6	12.1	3.9%
Q	M	USD	3.67	6.00	-45.9%	-0.40	-0.30	-0.13	NM	NM	NM	0.0%
SPX			1049.48			47.95	52.75	55.50	21.9	19.9	18.9	1.6%

O – Outperform, M – Market-Perform, U – Underperform

Highlights

This Research Call is the first in our series examining the economics of DSL from the RBOC perspective. This call sets up our current forecast for the consumer broadband market and DSL, specifically by outlining the subscriber and pricing assumptions underlying our industry models and RBOC forecasts.

- The market for DSL services is estimated to grow 22% annually over the next five years off a 2003E base of \$2.5B. Underlying that outlook is a broadband subscriber growth forecast calling for 26% growth modestly offset by price decay averaging (5.6)%.
- We expect broadband penetration of total US households to improve from 15% in 2002 to 58% in 2008, driven by modest gains in online penetration of PC households, an improving price/performance ratio vis a vis dial-up, and internet content increasingly designed for broadband connections.
- Within the mix of on-line subscribers, DSL is expected to gain 19 percentage points of share, shifting a 17% / 7% / 76% subscriber share ratio for cable/DSL/Dial-up in 2002 to 46% / 27% / 25% by 2008E.
- We see current DSL monthly churn rates of nearly 5% – 200bp higher than cable modem rates – as temporary and driven half by poor customer targeting and post-sale follow-through and half by competitive churn. Over time, DSL churn rates will migrate toward cable modem levels of 3%, with improved customer targeting, provisioning and a better value proposition driving the gains.
- At \$2.5B, consumer DSL remains a small revenue stream in the context of the RBOCs' \$160B combined 2003E topline, accounting for little less than 2% of the total. However, over the next five years, DSL will drive greater than 15% of the RBOCs' topline growth.

Investment Conclusion

While the consumer broadband market will continue to be an important facet of the RBOCs' strategies over the next five years, it is unlikely to offer sufficient growth to offset much of the compression expected elsewhere in the companies' core wireline business. We anticipate incremental share shifts in DSL's favor – magnified by improvements in churn – to be taken positively by the market, although recent price reductions and the drag from higher subscriber acquisition costs (due to higher gross adds) will mask much of the positive potential impact. While we are neutral on the group, we maintain that investors should



exercise caution in being naked the sector as the cyclical sensitivity of telecom revenues is generally underestimated and the RBOCs are paying dividends sufficient to justify the wait for a recovery. Within that context, we recommend SBC among the RBOCs for its statistically aberrant dividend yield (both absolute and relative to the S&P), for its positive exposure to the upcoming FCC wholesale pricing (TELRIC) debate, and for its greater level of DBS-Wireline bundle integration suggesting, perhaps, a longer wait before fiber-to-the-premise spending begins (though with the concurrent risk of a negative earnings surprise if the company is successful selling bundled services). We rate SBC Outperform with a \$30 DCF-based estimate of fair value. We rate Verizon, BellSouth and Qwest all Marketperform with \$38, \$29 and \$6 DCF-based estimates of fair value, respectively.

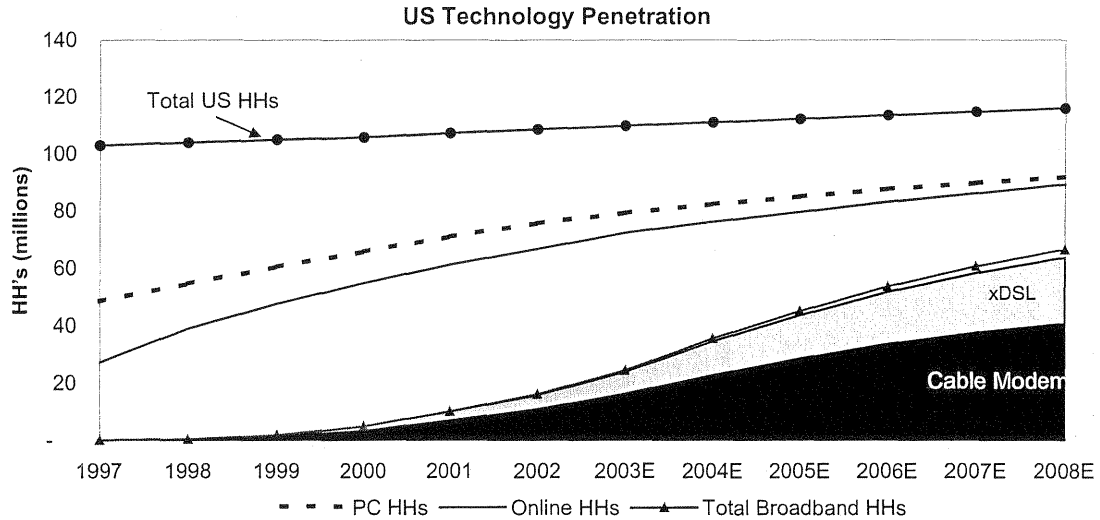
Details**Current Online Market Forecast**

As noted in our joint *Research Call* with Bernstein's Cable and Media teams on July 15, 2003 ("Broadband Market Shaping Up to be Bigger than Generally Appreciated"), we view the opportunity for consumer DSL services to be larger, faster growing and more stable than commonly believed. Over the next five years, we estimate the total market for consumer broadband services will grow at an average annual rate of 18% off an estimated revenue base of \$8.6B for 2003, with DSL gaining significant share at the expense of dial-up. Driving this outlook are two dynamics: (1) accelerating penetration rates driven by recent RBOC DSL price reductions, and (2) a shift towards websites sporting bandwidth-demanding content (e.g., streaming music videos and movie trailers) making the narrowband experience ever-more unpleasant.

Relative to penetration, continued growth in PC households will drive a technological push towards on-line services which, in turn, will translate into increased demand for broadband services. **Exhibit 1** and **Exhibit 2** show our current forecasts for PC, online and broadband penetration of US households, as well as broadband subscribers by technology. As can be seen from the exhibits, 70% of households had PCs at year-end 2002 while 88% of those claimed to have Internet access. Within the online subset of households (62% of total households), nearly 25% were using broadband access connection at year-end 2002 with fully a third expected by year-end 2003 (i.e., DSL, Cable Modem, Satellite-DSL hybrid, etc.). As **Exhibit 3** shows, we expect broadband's penetration of online households to climb steadily over the next five years reaching 73% of online subscribers or nearly 66 million households by 2008. Of the available broadband options, we expect DSL's share of subscribers to increase by no less than 500bp off a 2003 market share of 30% as the value proposition of DSL vis a vis cable and dial-up is becoming more attractive and because the carriers' target marketing and provisioning is improving, cutting churn longer-term to levels approaching those of the cable companies at ~3%.

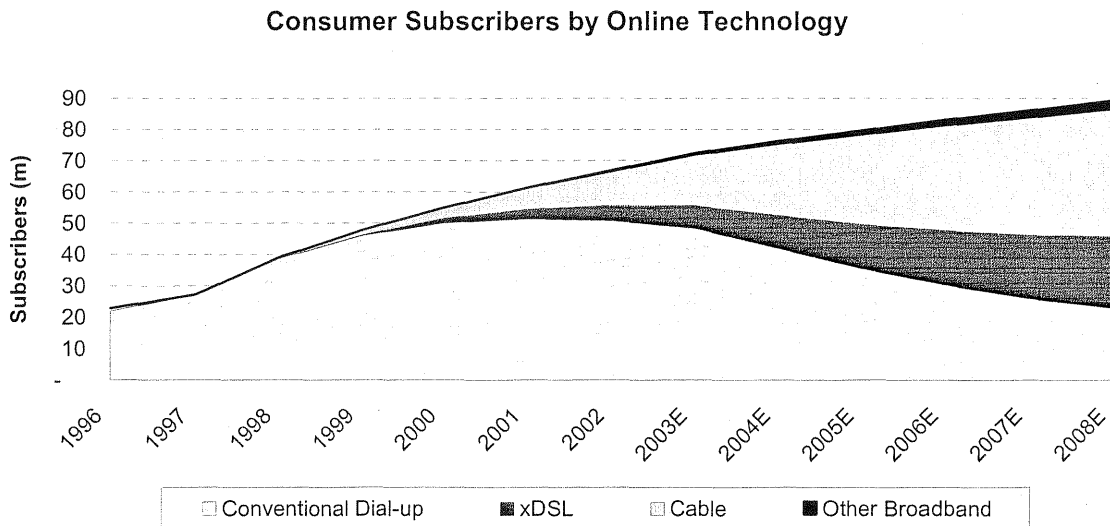


Exhibit 1
Consumer Internet Market by Connection Type



Source: Company Reports, Nielsen and Bernstein Estimates

Exhibit 2
Consumer Online Connections by Type



Source: Company Reports, Nielsen and Bernstein Estimates

Broadband Update: DSL Share Reaches 40% of Net Adds in 4Q; Overall Growth Remains Robust

Stock	4/7 Price	SCB Rating	YTD Rel. Perf.	52-Week Range	EPS			P/E		Current Yield
					2003	2004E	2005E	2004E	2005E	
BLS	\$26	M	(5)%	\$21 - \$31	\$2.07	\$2.08	\$1.89	12.5x	13.8x	31.6%
SBC	24	M	(6)	19 - 27	1.55	1.43	1.28	16.8	18.8	4.9
VZ	37	M	6	31 - 41	2.62	2.36	2.31	15.7	16.0	4.1
Q	4	O	(3)	3 - 5	(0.38)	(0.35)	(0.03)	nm	nm	-
CMCSA	29	O	(13)	27 - 36	(0.04)	0.45	0.75	64.4	38.6	-
COX	31	O	(11)	25 - 34	(0.22)	0.37	0.54	83.8	57.4	-
CVC	22	M	(6)	15 - 24	(1.04)	(1.30)	(1.18)	nm	nm	-

Overview

DSL net subscriber additions share versus cable reached 39.7% in the fourth quarter, reflecting renewed RBOC emphasis on marketing and promotion of DSL services, improvements in customer quality of service and expanded availability. We expect cable's share of broadband subscribers to fall from 67% at the end of 2003 to just under 60% in 2008, while DSL's share grows from 30% to 33%.

The consumer broadband market grew by 43% in 2003, adding seven million subscribers to bring total broadband households to 24 million. Erosion of the dial-up market continues at a rapid pace. The four largest dial-up ISPs lost a total of 900,000 narrowband subscribers during the fourth quarter, and 4.6 million subscribers for the year.

We expect continued strong growth in 2004, with the market growing by over nine million subscribers. We forecast that consumer broadband subscribers will grow at an average annual rate of 22% over the next five years, from a 2003 base of 24 million to 65 million in 2008.

We expect continued erosion of pricing for both cable and DSL, with annual ARPU declines of 5% and 8%, respectively, as bundling, promotion and tiering all contribute to lower price realization.

While we expect DSL to continue gaining share of net adds versus cable, consumer broadband is unlikely to offer sufficient upside to offset much of the compression expected elsewhere in the RBOCs' core wireline business. We remain neutral on the telecom group.

Broadband growth remains a key underpinning of continued cable revenue growth. We continue to recommend investors overweight the cable group.

Online Market Forecast

With full-year 2003 results now reported for the large broadband service providers, we have revisited our broadband subscriber penetration estimates and net add forecasts. As predicted in our last overall market forecast, *Weekly Note* July 18, 2003, "Broadband Market Bigger Than Expected," the market has sustained stronger-than-consensus growth, finishing the year at 24.1 million subscribers. As forecast, DSL has gained market share over the period on the back of more aggressive pricing and faster additions to availability. We continue to view the opportunity for consumer cable modem and DSL services to be larger, faster growing and more stable than commonly believed.

Over the next five years, we estimate the total market of broadband services subscribers will grow at an average annual rate of 22% off a base of 24.6 million in 2003, with both DSL and cable gaining significant share at the expense of dial-up (see Exhibit 1). Driving this outlook are two dynamics: (1) continued strong growth in penetration rates as the RBOCs and cable more effectively market and deliver on the value proposition of DSL and cable modem service; and (2) a shift towards Web sites sporting bandwidth-demanding content making the narrowband experience ever more unpleasant. The RBOCs will enjoy faster growth, benefiting from a smaller base, as well as continued increases to market share.

Of the available broadband options, we expect DSL's share of the installed base of broadband subscribers to increase from 30% to 33% in 2008 as the value proposition of DSL versus cable and dial-up

Exhibit 1 Consumer Internet Access Technology: Top-Down Forecast

(Million Households)	2002	2003	2004E	2005E	2006E	2007E	2008E
Online Technology — Households							
Conventional Dial-Up	50.2	48.5	43.0	37.2	32.0	27.6	24.3
xDSL	5.0	7.3	10.6	14.0	17.0	19.6	21.7
Cable	11.5	16.2	21.9	27.2	31.9	35.8	38.9
Other Broadband Online	0.3	0.6	1.0	1.4	2.4	3.4	4.6
Total Online Households	67.0	72.6	76.4	79.8	83.3	86.3	89.5
Memo: Broadband Households	16.8	24.1	33.4	42.6	51.3	58.8	65.2
Online Technology — Share							
Conventional Dial-Up	74.9%	66.8%	56.2%	46.6%	38.4%	31.9%	27.1%
xDSL	7.4	10.1	13.9	17.6	20.5	22.7	24.3
Cable	17.2	22.3	28.6	34.1	38.3	41.4	43.5
Other Broadband Online	0.4	0.8	1.3	1.8	2.9	3.9	5.1
Memo: Total Broadband	25.1	33.2	43.8	53.4	61.6	68.1	72.9

Source: Nielsen Research, corporate reports and Bernstein estimates.

improves, and the RBOCs continue to focus on service improvements and churn reduction.

DSL Continues to Grow Market Share vs. Cable

Aggregate fourth-quarter net additions for the RBOCs grew at over 42.1% year-over-year, representing an acceleration from the 31% seen in the third quarter of 2003. By contrast, cable net additions were actually down slightly (3.1)% from the year-ago period, after notching year-over-year growth of nearly 8.5% in the third quarter. Although DSL continues to lag cable in absolute number of additions, DSL's market-share gains represent a clear trend toward convergence of market share, as forecast in our July report.

DSL's share gains reflect four factors:

- A modest narrowing of cable's *gross* addition lead, based on DSL's more aggressive pricing and narrowing availability disadvantage;
- Falling DSL churn rates, as RBOC installation and service levels improve (resulting in higher net additions as fewer customers are lost to churn);
- The law of large numbers, as cable modem churn rates apply to its larger installed base (requiring an *acceleration* of gross addition share in order to maintain net addition share); and
- RBOCs continued to expand DSL-addressable homes in 2003. Though most of these infrastructure upgrades are complete, Qwest plans to expand availability from 45% to 60% in 2004.

DSL's market share gain of *gross* additions — where the battle for new customers is actually fought — reflects its lower pricing as introduced in May 2003, coupled with a narrowing of cable's historical availability advantage. We estimate that

cable's share of gross additions has fallen from 64% to 59% over the past year. Share of *net* additions continues with the same trend, but is exacerbated by improving churn rates as DSL providers have focused on customer quality of service, marketing and promotion, and expanded availability. Cable's fourth-quarter market share of net additions fell to 60.2%, from 65.5% in the third quarter of 2003, with DSL's share growing by a like amount.

Since the pricing actions from Verizon and SBC in early 2003, prevailing *à la carte* DSL rates have remained at a \$5-\$10 per month discount to cable modem service (generally \$39.99 or \$34.99 versus typical cable rates of \$44.99 per month). Over the same period, promotional rates have settled at approximately \$29.99 per month for both cable and DSL, although the Bells' "promotional" bundled discounts tend to run indefinitely versus cable's, which roll off typically in three to six months. The most interesting change over the last several months was a rise in SBC's lead-offer price at the beginning of February, from \$26.95 to \$29.95, which seems to have temporarily alleviated concerns of a price war in high-speed Internet access, despite the fact that only a fraction of SBC net adds qualified for it.

DSL's share gains also reflect a shrinking "availability gap," as forecast in our July report. At the end of the fourth quarter of 2003, broadband service was available to an estimated 92.3% of cable subscribers nationally, up 540 bp from 86.9% at the time of the RBOC price cuts (after the first quarter). By contrast, DSL's availability expanded by 790 bp over the same period, from an access line-weighted 65.7% at the end of the first quarter to 73.6% today. (Investors should note that the denominators for DSL and cable-modem service are not perfectly comparable; RBOCs' available homes approximate 100% of households, less those which